J.L. Kichline
December 16-17, 1985

FOMC BRIEFING

The staff's forecast prepared for this meeting of the Committee is, on the whole, about unchanged for the current and next quarter, but a shade weaker later on in 1986. The downward revision to expected real growth next year stems mainly from a reassessment of the fiscal assumptions in light of the enactment of the Gramm-Rudman legislation, and we now have somewhat more fiscal restraint built into the forecast. For all of 1986 real GNP is projected to rise 2 percent or the same as expected for this year. On the price side there have not been any significant changes and we still project inflation to show a little uptick in response to the lower foreign exchange value of the dollar, but to remain under 4 percent.

In the current quarter, our reading of the available information generally is consistent with the earlier notion that real GNP is expanding at a 2-1/2 percent annual rate. The labor market reports have been upbeat with nonfarm employment increasing 180,000 in November after a much larger gain in the preceding month; the unemployment rate in November dipped a tenth to 7 percent. Increases in employment continue to be concentrated in the services area, although manufacturing employment edged up after a larger gain in October. Industrial output is estimated to have increased 0.4 percent last month as most major categories of production rose, but the level of output was only fractionally above the third-quarter average given the September and October decline.

Retail sales excluding autos were reported to have risen strongly in November after a sluggish performance in October. Reports from retailers on post-Thanksgiving sales present a mixed picture and are very difficult to interpret, but we would judge sales to be up moderately. Automobile sales in November remained depressed for domestic models, and manufacturers reintroduced some limited financing incentives. Early in December sales picked up to near 7-1/2 million units annual rate, a level that is still below recent and planned production.

Housing starts in October finally demonstrated some life even though new home sales had weakened in that month and the two preceding months. Unfortunately, the Census Bureau provided a surprise this morning, reporting that starts in November fell 200,000 units annual rate to 1.55 million. The decline was concentrated in single-family units and occurred across all regions. Those numbers are not readily explicable, although mortgage interest rates are even lower now and we would still expect housing to be a growth sector over the forecast period.

Business fixed investment spending seems likely to expand sluggishly this quarter. A rise in nondefense capital goods shipments including IBM's new Sierra mainframes is expected to be damped by a reduction in business purchases of autos and weakness in nonresidential construction outlays. Business inventory investment is projected to contribute substantially to growth of real GNP this quarter in association with the rebuilding of auto stocks. I should note, however, that retail inventories excluding autos showed unexpected rapid accumulation in October, and to hit the staff forecast manufacturing and trade inventories excluding autos will need to be essentially flat over the balance of the quarter.

Government purchases and net exports are not expected to influence significantly growth in GNP this quarter, although they are quite important elements in the staff's forecast for 1986. Net exports next year are projected to account for about 1/2 percentage point of the growth in real GNP as the reduced foreign exchange value of the dollar helps boost exports and cuts into import volume.

In contrast, the government sector acts as a drag on the economy as a result of the assumed fiscal restraint. In this forecast the staff has assumed that the first stage Gramm-Rudman cuts amounting to $12 billion will go into effect next March 1; however, because of slippage in reaching earlier outlay objectives, we have a net reduction of only about

$5 billion from the assumption we had made in previous forecasts. The impact of the additional restraint is partly offset by the effect of lower interest rates which leads to somewhat higher spending than otherwise in interest sensitive sectors, notably housing.

The degree of uncertainty attached to the staff's or any other forecast for 1986 it seems is rather large at this juncture. There indeed are substantial risks connected with the underlying assumptions as well as developments in individual sectors of the economy. As to the assumptions themselves, we have a further moderate decline in the dollar in prospect although clearly one could pick out uncertainties in both directions. For fiscal policy the assumed total deficit-reducing actions in the forecast of $50 billion for fiscal year 1986 still give a deficit a little over $190 billion. With a Gramm-Rudman objective of $144 billion for the next fiscal year, it is not at all clear how fiscal policy will evolve as the year progresses. As to risks in some individual sectors I might note the case of consumer spending where the staff is projecting 2 percent growth next year. That is sluggish growth compared to recent experience, but we have tried to balance the stimulative effects of now lower interest rates and higher wealth against prospective slow growth of disposable income, an already low saving rate, and high debt burdens. Whether or not we have weighted these and other considerations correctly is, of course, open to debate.

On the inflation side, recent monthly price numbers have been higher than earlier in the year, reflecting what is believed to be a temporary rise in food and energy prices. Livestock prices surged this fall but indications from futures markets are that those prices will fall somewhat in the first half of next year. Energy prices also rose somewhat in the past couple of months although oil prices have since declined and we expect flat energy prices next year. Overall, the price forecast indicates only a small rise next year in association with the lower value of the dollar.

FOMC Briefing
SHAxilrod/pjd
December 16, 1985

The alternatives presented to the Committee indicate that M1 can be expected to slow sharply from its recent pace even with interest rates around recent levels or a bit lower. The bases for such a judgment are, one, the results of the staff's quarterly and monthly money demand models and, two, the belief that the level of demand deposits has already risen well beyond the need for them in relation to current and prospective increases in income. Both bases have admittedly and to say the least been shaky over the past several months, but while M1 growth has been stronger than expected, at least it has decelerated--to just under 8 percent annual rate on average over the three months ending in November from just over a 16-1/2 percent annual rate over the three months ending last August.

While some further deceleration may be in prospect, after a potential bulge in December, it has to be kept in mind that M1 seems highly sensitive to interest rate developments, particularly in the current range of market rates when the opportunity costs of holding highly liquid balances like NOW accounts is quite low. The odds on a further deceleration are much the greatest if rates stabilize or rise. Some further downtrend of rates, on the other hand, could well trigger sizable inflows into NOW accounts. Even if that were to develop, though, it may not be accompanied by any substantial acceleration of M2, given the quite moderate growth in GNP that we are projecting, unless there was a temporary surge of market funds shifting into MMDAs or money funds as adjustments in their rates lagged further market rate declines.

The potential for unfavorable economic developments--either undesired weakness in economic activity or accelerated price inflation--

seems less embedded in the behavior of the aggregates at this point in time--assuming all of the aggregates do not more or less together either accelerate or decelerate--than it does in other factors. The potential for economic weakness--while partly related to lingering adverse effects of the unexpected earlier strength of the dollar--is also a product, from a financial perspective, of relatively high real market interest rates. They have probably become a constraining force in the plant and equipment and residential construction areas as ebullience from the initial surge in demand in the period of rapid recovery has waned, as expectations of "inflationary" profits have become or are becoming more muted, and if, or as, fiscal restraint does eventuate.

Looking at the inflationary side, on the other hand, the behavior of the exchange rate seems under current circumstances to be the key element. With commodity prices weak and unit labor costs at least not showing a tendency to accelerate significantly, a sharp drop in the dollar seems to be the main threat for setting off a price acceleration. In that context, the rapid rise of M1 over the past several months would provide a permissive financial background, in the sense that the cash is there readily to finance transactions, even though the M1 expansion in and of itself seems unlikely to initiate further inflationary tendencies.

The room for maneuver for monetary policy in these circumstances depends in part on one's assessment of the nation's underlying growth potential, and on the trade-off between price behavior and the degree of economic expansion at this point in time. With regard to current policy options, if the Committee opted to keep bank reserve conditions unchanged, it seems unlikely that interest rates as a whole or the exchange rate would decline much further--and they could back up some--unless current economic indicators were clearly weak. Some little easing in bank reserve conditions may not entail undue risk of initiating a very sharp further drop of the dollar along with some farther decline of interest rates, since some easing has already been anticipated by markets. But that is obviously the policy direction that has the greatest risk of causing the dollar to become unstuck. Thus, should the Committee decide to head in an easing direction, it may wish to temper any such moves in light of behavior of the exchange rate. Indeed, under current circumstances, it is probably not too much of an exaggeration to say that, insofar as effects on the economy as a whole are concerned--considering both real and price developments--there may be some trade-off between interest rate and exchange market developments, with a decline in the dollar in some degree substituting for a decline in rates and vice-versa.